

Internal Revenue Service

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Person To Contact:

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Date: APRIL 28, 2008

In Re:

Legend:

Decedent =

Date 1 =

Daughter=

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Will =

Company =

Trust 1 =

a =

Trust =

Bank =
Trust 2 =
Date 2 =
b =
c =
i =
n =
Date 3 =
d =
Date 4 =
Date 7 =
Date 5 =
Date 6 =
Court =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Spouse =
Daughter's Will =

y =

Dear :

This is in response to a letter dated November 19, 2007, and other correspondence, requesting rulings on behalf of Decedent's estate, Trust 1, Trust, and Trust 3, regarding the allocation of Decedent's generation-skipping transfer (GST) exemption.

Facts

The facts submitted and representations made are as follows. Decedent died on Date 1, survived by Daughter. Daughter subsequently had three children: Grandchild 1, Grandchild 2, and Grandchild 3.

Under Decedent's Will, Bank is named as executor of Decedent's estate and Trustee of each trust established under Will. Will provides that all transfer, estate, inheritance, succession and other death taxes, including generation-skipping transfer tax, will be paid from and apportioned among the property of Decedent's estate as the executor, in its sole discretion, may determine. All other debts and expenses of administration of the estate, unless otherwise expressly provided elsewhere in the Will,

will be paid from the residuary estate. Will further provides that, except as otherwise provided in Will, the income on the part of Decedent's estate used to pay federal estate taxes or state death taxes will be paid to the income beneficiaries of any trust to which the property has been bequeathed, and, if none, to the income beneficiaries of the residuary estate.

Under Will, all of Decedent's stock in Company, a closely-held subchapter S corporation, passes to Trust 1, an irrevocable trust Decedent established during his life. In addition, \$a passes to each of two named individuals, if the individual survives Decedent.

Under Will, the residue of Decedent's estate passes to Trust for the benefit of Daughter. Under the terms of Trust, Trust income was to be paid to Daughter, in the trustee's discretion, until Daughter reached age 21, and thereafter, all of the net income was to be paid to Daughter at least quarterly. The trustee had discretion to distribute principal to Daughter for specified purposes. Daughter was to receive one-third of the principal of Trust at age 25; one-half at age 30; and the balance at age 35. If Daughter died before receiving the entire principal of Trust, the remaining principal would be distributed among the surviving descendants of Child, if any, per stirpes, and if none, in specified amounts to a named individual and two named charities. Any property that is to be distributed to a beneficiary under age 21 may be held in trust for the benefit of that beneficiary. Any part of income or principal of a trust for a beneficiary under age 21 may be used to provide for the beneficiary's proper support and education. If the beneficiary dies before reaching age 21, the property remaining in his or her trust will be distributed to the personal representative of the beneficiary's estate.

Trust 1, which was intended to qualify as a Qualified Subchapter S Trust, held stock in Company among other assets. The income of Trust 1 was payable to Daughter under terms conditioned upon whether Decedent was living and whether an election was made for the trust to be an eligible Subchapter S corporation shareholder. The trustee had discretion to distribute principal to Daughter for specified purposes. Daughter was to receive one-third of the principal of Trust 1 at age 25, one-half at age 30, and the balance at age 35. Daughter had a testamentary general power to appoint the remaining principal of Trust 1 if she died before receiving the entire principal. Any part of the Trust 1 assets Daughter failed to appoint would be distributed per stirpes among her descendants or held in separate trusts for the benefit of such descendants who were under age 35. Bank is currently serving as trustee of Trust 1.

During his lifetime, Decedent also established another irrevocable trust, Trust 2, to hold life insurance on Decedent's life. The income of Trust 2 was payable to Daughter under terms conditioned upon whether Decedent was living and whether Daughter had reached age 21. The trustee had discretion to distribute principal to Daughter for specified purposes and could also distribute principal for the support and

education of Daughter's descendants. Daughter was to receive one-third of the principal of Trust 2 at age 25; one-half at age 30; and the balance at age 35. If Daughter died before receiving the entire principal of Trust 2, the remaining principal was to be distributed among the surviving descendants of Daughter. Each share for such descendant may be held in a separate trust until that descendant reaches age 21. Any part of income or principal of a trust for a descendant of Daughter may be used to provide for the descendant's proper support and education. If a descendant dies before reaching age 21, the property remaining in his or her trust will be distributed to the personal representative of the descendant's estate. Decedent could not serve as trustee of Trust 2, and Bank is currently serving as trustee of Trust 2.

On Date 2, Bank, as executor of Decedent's estate, requested an extension to file Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, for Decedent's estate and paid \$b, a portion of the estate tax due. On that date, Bank also timely paid the entire state estate tax liability of \$c. The principal asset of the estate was Decedent's Company stock which represented l percent of the total issued stock in Company and almost n percent of the adjusted gross estate. On Date 3, Bank timely filed the Form 706 for Decedent's estate and elected under § 6166 to defer payment of the \$d balance of the federal estate tax. On the Schedule R attached to the Form 706, the estate allocated Decedent's entire GST exemption to Trust 1. Decedent did not allocate any part of his GST exemption during his life.

On Date 5, Bank, as executor, petitioned Court for an order authorizing it to use income generated from the assets of the probate estate (primarily Company stock) to pay the estate's outstanding debts, taxes, and expenses of administration. On Date 6, Court issued an order authorizing the estate to pay debts, taxes, and expenses of administration from the estate's income. From on or about Date 4 through Date 7, the estate paid the deferred federal estate tax, the interest, and other expenses of the estate from the income generated by the assets of the estate. On Date 8, the Company stock was transferred to Trust 1. Subsequently, Trust was funded from Date 9 through Date 10 with assets totaling \$y in value.

Daughter died on Date 11, after reaching age 25 but before attaining age 30. She was survived by her Spouse and her minor children, Grandchild 1, Grandchild 2, and Grandchild 3. Under Daughter's Will, Daughter exercised her testamentary power to appoint the assets of Trust 1 by appointing all Trust 1 assets to her residuary estate. Under the terms of Daughter's will, the residue passed to trusts for the benefit of Grandchildren 1, 2, and 3.

As a result of Daughter's death, the remaining assets of Trust and Trust 2 are being held in Trust for the benefit of Daughter's minor children, Grandchildren 1, 2, and 3. No distributions have been made from either trust since Daughter's death. The only distributions from either trust were made to Daughter before her death.

During the administration of Daughter's estate, it was determined that on the Form 706 filed for Decedent's estate, Decedent's GST exemption had been erroneously allocated to Trust 1, a trust that had no GST potential with respect to Decedent, in view of Daughter's general power of appointment.

Taxpayer has requested the following rulings:

1. The allocation to Trust 1 of Decedent's GST exemption on the Schedule R attached to the Form 706 filed for Decedent's estate was void under § 26.2632-1(d)(1) of the Generation-Skipping Transfer Tax Regulations, because Trust 1 had no GST potential with respect to Decedent.

2. Because the allocation of Decedent's GST exemption was ineffective, Decedent's GST exemption was automatically allocated, under §§ 2632(e) and 26.2632-1(d)(2), pro rata to Trust 1 at its chapter 11 value and to Trust 2, based on the respective value of each trust on Decedent's date of death.

Law and Analysis:

Section 2041(a)(2) provides that the value of the gross estate shall include the value of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by disposition which is of such a nature that if it were a transfer of owned by the decedent, such would be includible in the decedent's gross estate under §§ 2035 to 2038. Section 2041(b)(1) provides that for purposes of § 2041(a), the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except if such power is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent.

Section 2601 imposes a tax on every generation-skipping transfer (GST). A GST is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2631(a) (in effect at the time of Decedent's death) provides that, for purposes of determining the GST tax, every individual shall be allowed a GST exemption of \$1,000,000 which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Under § 2632(a) and § 26.2632-1(d)(1) of the Generation-Skipping Transfer Tax Regulations, an allocation of a decedent's unused GST exemption by the executor of the decedent's estate is made on the appropriate United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706 or Form 706NA) filed on or before the date prescribed under § 6075(a) for filing the return (including any extensions actually granted (the due date)). An allocation of GST exemption to a trust is void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor for whom the allocation is being made, as of the date of the transferor's death.

Under § 2632(e)(1) and § 26.2632-1(d)(2), a decedent's unused GST exemption is automatically allocated on the due date for filing the Form 706, or Form 706NA, to the extent not otherwise allocated by the decedent's executor on or before that date. Unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)), on the basis of the value of the property as finally determined for purposes of chapter 11 (chapter 11 value), first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)) on the basis of the chapter 11 value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. The automatic allocation is irrevocable.

Section 2602 provides that the amount of the tax is the taxable amount multiplied by the applicable rate. Section 2641(a) defines "applicable rate" as the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer. Under § 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is generally defined as the excess of 1 over the "applicable fraction." The applicable fraction, as defined in § 2642(a)(2), is a fraction, the numerator of which is the amount of GST exemption under § 2631 allocated to the trust (or to property transferred in a direct skip), and the denominator is the value of the property transferred to the trust or involved in the direct skip.

Section 26.2642-1(c) provides that the denominator of the applicable fraction is the value of the property transferred to the trust reduced by the sum of (i) any federal estate tax and any state death tax incurred by reason of the transfer that is chargeable to the trust and is actually recovered from the trust, (ii) the amount of any charitable deduction allowed under section 2055, 2106, or 2522 with respect to such transfer, and (iii) in the case of a direct skip, the value of the portion of the transfer that is a nontaxable gift.

Section 26.2642-2(b)(1) of the Generation-Skipping Transfer Tax Regulations provides that, in general, in determining the denominator of the applicable fraction, the

value of property included in the decedent's gross estate is its value for estate tax purposes.

Section 2652(a)(1) provides that for purposes of chapter 13 the term "transferor" means: (A) in the case of any property subject to the tax imposed by chapter 11, the decedent; and (B) in the case of any property subject to the tax imposed by chapter 12, the donor. An individual shall be treated as transferring any property with respect to which such individual is the transferor.

In the present case, under the terms of Trust 1, as of the date of Decedent's death, Trust 1 was either subject to complete distribution to Daughter if she survived until age 35, or subject to Daughter's testamentary power of appointment if she died prior to age 35. Daughter's testamentary power to appoint the Trust 1 corpus constituted a general power of appointment within the meaning of § 2041. Thus, as of the date of Decedent's death, the entire Trust 1 corpus was subject to inclusion in Daughter's gross estate under either § 2033 (to the extent corpus was distributed to Daughter), or under § 2041, in the event Daughter died before attaining age 35. Consequently, under either scenario, as of the date of Decedent's death, under § 2652(a)(1), Daughter would become the transferor of Trust 1 for purposes of the GST tax. Accordingly, based on the facts submitted and representations made, we conclude that the allocation to Trust 1 of Decedent's GST exemption on the Schedule R attached to the Form 706 filed for Decedent's estate was void, under § 26.2632-1(d)(1), because Trust 1 had no GST potential with respect to Decedent.

Further, we conclude that, because the allocation of Decedent's GST exemption was ineffective, Decedent's GST exemption was automatically allocated, under §§ 2632(e) and 26.2632-1(d)(2), on a pro rata basis, to Trust 2 (based on the value of Trust 2 on the date of Decedent's death), and to Trust. In this regard, with respect to Trust, in determining the denominator of the applicable fraction, the value of Trust as of Decedent's date of death is determined in accordance with § 26.2642-1(c), and is not reduced by any state and federal estate taxes that were paid from sources other than Trust, such as the Trust 1 income. However, we are specifically not ruling on the date of death value of Trust and Trust 2.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

George Masnik, Chief
Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure

Copy for section 6110 purposes